

IRS Issues Guidance Regarding Credits and Refunds of Tax Withheld from International Payments

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Notice 2015-10

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April 29, 2015

On April 28, 2015, the Internal Revenue Service ("IRS") issued Notice 2015-10 (the "Notice") providing guidance to persons seeking credits or refunds with respect to tax withholding on payments to foreign persons. The Notice provides that the IRS will disallow refunds or credits on amounts withheld to the extent the withholding agent failed to deposit the amounts required to be withheld with the U.S. Treasury. The Notice announced the IRS' intent to issue regulations that provide that an otherwise allowable claim for refund or credit made by a foreign claimant with respect to a withheld amount is only available to the extent that the relevant withholding agent actually deposited the amounts withheld. The effect of the Notice is to shift to the beneficial owner of the payment the risk that amounts withheld may not have been deposited.

Background

Chapter 3 of the Internal Revenue Code (the "Code") generally requires withholding agents to collect the tax liability of foreign persons imposed under sections 871(a) and 881(a) on payments of U.S. source fixed or determinable annual or periodical income ("FDAP income") through withholding on such payments. Under the Foreign Account Tax Compliance Act, or "FATCA," Chapter 4 of the Code generally requires withholding agents to withhold tax on payments to foreign financial institutions ("FFIs") and certain nonfinancial foreign entities ("NFFEs") that do not provide

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information regarding their U.S. account holders or substantial U.S. owners, respectively. Taxes withheld under Chapter 3 and Chapter 4 are collected primarily by domestic withholding agents, however foreign persons may also be withholding agents.

A withholding agent is required to deposit all amounts withheld under Chapter 3 and Chapter 4 with the U.S. Treasury within certain time periods in accordance with Code section 6302. A withholding agent is required to report its federal income tax liability for the amounts required to be withheld on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, for each calendar year. If the total amount of deposits received by the U.S. Treasury is less than the withholding tax liability of the withholding agent, the withholding agent remains liable for the taxes due. A withholding agent is required to file with the IRS and furnish to the recipient of a reportable payment a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, reporting amounts withheld with respect to payments to the recipient.

Occasionally over-withholding occurs and the beneficial owner of the payment is due a credit or refund for the over-withheld amount. For example, a foreign person's self-reported FATCA status may differ from its status as determined by the withholding agent. In these and similar situations under Chapter 3 regarding entitlement to treaty benefits, the withholding agent may take a more conservative position and withhold at the maximum withholding tax rate and direct the beneficial owner of the payment to seek a refund of any over-withholding. Current regulations under Chapter 3 and Chapter 4 provide that a refund or credit of an amount of tax that has actually been withheld by the withholding agent at the time of payment will be made to the beneficial owner of the payment to which the withheld tax relates if such owner files a U.S. income tax return and attaches a copy of the Form 1042-S to the return.

The Notice provides that an otherwise valid claim for refund or credit with respect to over-withheld amounts will be denied in whole or in part if the withholding agent failed to remit the withheld amounts to the U.S. Treasury. No credit or refund will be allowed for amounts withheld under Chapter 3 or Chapter 4 to the extent there is a shortfall in the deposits required to be made by the withholding agent. In cases where the withholding agent has deposited a portion of the amount of tax that it has withheld under Chapter 3 and Chapter 4, the regulations will provide that the claimant is entitled to a partial refund or credit that takes into account that the withholding agent has deposited a portion of the required amount of tax. Future regulations will adopt a *pro rata* method to allocate the amount available for refund or credit with respect to each claimant.

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The Notice provides that the IRS is considering exceptions to the general rules described above and is seeking comments regarding the allocation of partial deposits and procedural rules contained in the Notice. Comments must be received by June 29, 2015.

Impact of the Notice and Future Regulations on Foreign Persons

The effect of the Notice and future regulations will be to place the risk (and the economic burden) that a withholding agent will fail to remit amounts withheld to the U.S. Treasury on the beneficial owner of the payment. As a result, and to avoid over-withholding, it will be increasingly important for foreign payees to timely submit valid withholding certificates to their withholding agents. If over-withholding occurs, the foreign payee may be unable to obtain a credit or refund if the withholding agent fails to remit the withheld amount. If the beneficial owner is denied a credit or refund under these rules, its only recourse may be to seek relief from the withholding agent directly, possibly through a court action.

The Notice is a departure from established policies regarding when taxpayers are eligible for tax refunds or credits, and it is in stark contrast to withholding rules in other contexts. For example, under Code section 31(a)(1), an employee is not precluded from obtaining a tax credit for income taxes withheld by his or her employer if the employer does not remit the withheld amounts to the U.S. Treasury.¹

General IPB Observations

Although the Notice is clearly aimed at protecting the U.S. Treasury from fraudulent claims and harmful practices, it nonetheless raises serious business and policy concerns in respect of persons transacting business across borders. In light of the dramatic departure from longstanding policy, one may question whether the Notice and its regulations are consistent with existing treaty obligations and the expectations of U.S. trading partners. Given the potential concerns associated with the Notice, foreign parties that transact business with U.S. counterparts (*e.g.*, a foreign licensor of intellectual property) will want to review relevant contractual provisions to ensure that adequate measures are in place to safeguard against over-withholding and withholding agent deposit failures. Similarly, U.S. and foreign withholding agents will want to review internal processes for making timely assessments of proper withholding tax due on outbound payments in order to avoid impaired relations with foreign vendors.

Validity of the Notice and Future Regulations

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The Notice and future regulations may be open to challenge as inconsistent with applicable statutes under the U.S. Supreme Court's analysis in *Chevron*.² Under *Chevron*, if the applicable statute is unambiguous, IRS regulations must "give effect to the unambiguously expressed intent of Congress."³ Code sections 1462 (pertaining to FDAP withholding) and 1474(b)(1) (pertaining to FATCA withholding) provide that the amount withheld shall be credited against the total income tax computed on the beneficial owner's income tax return. An additional requirement that the withholding agent remit the withheld amounts is arguably inconsistent with the relevant statutes.

Contact Ivins, Phillips & Barker

Ivins, Phillips & Barker advises its clients on a wide range of international tax issues including those related to FDAP and FATCA withholding. We advise foreign beneficial owners, and U.S. and foreign withholding agents, on withholding and reporting obligations under Chapters 3 and 4 and the validity of regulations thereunder. Please contact Brian Davis, Patrick Smith or Douglas Andre if you have any questions about Notice 2015-10 or international withholding issues. For employee benefits-related questions, please contact Rosina Barker or Jonathan Zimmerman. We can be reached by phone or e-mail as indicated above.

¹ See Treasury Regulations § 1.31-1(a), ("If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer.").

² *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

³ *Id.* at 843.